The Offshore Reinsurance Tax Fairness Act

Overview of Issue

Offshore businesses that reinsure risks and that invest in U.S. hedge funds create the potential for tax avoidance of hundreds of millions of dollars. In these arrangements, a hedge fund or hedge fund investors make a capital investment in an offshore reinsurance company. The offshore reinsurance company then reinvests that capital (as well as premiums it receives) in the hedge fund. The owners of the reinsurer take the position that they are not taxed on corporate earnings until either those earnings are distributed, or the investors sell the corporation's stock at a gain reflecting those earnings.

The passive foreign investment company ("PFIC") rules of U.S. tax law are designed to prevent U.S. taxpayers from delaying U.S. tax on investment income by holding investments through offshore corporations. The PFIC rules provide an exception for income derived from the active conduct of an insurance business. The exception applies to income derived from the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under Subchapter L if it were a domestic corporation.

Current law does not prescribe how much insurance or reinsurance business the company must do to be considered predominantly engaged in an insurance business. Senate Finance Democratic staff investigative efforts show that some companies that are not legitimate insurance companies are taking advantage of this favorable tax treatment.

Legislative Fix

The Offshore Reinsurance Tax Fairness Act would provide a bright-line test for determining whether a company is truly an insurance company for purposes of the exception to the PFIC rules.

Under the new rule, to be considered an insurance company, the company's insurance liabilities must exceed 25% of its assets. If the company fails to qualify because it has 25% or less (but not less than 10%) in insurance liability assets, the company may still be predominantly engaged in the insurance business based on facts and circumstances. A company with less than 10% of insurance liability assets will not be considered an insurance company and, therefore, would be ineligible for the PFIC exception and subject to current taxation.

Legitimate insurance companies will be able to meet the 25% test. Those that do not meet the test and are truly involved in the insurance business will be eligible for the PFIC exception based on a facts and circumstances determination. We believe the rule disqualifying companies with less than 10% of insurance liability assets should target most of the hedge fund reinsurance companies that are taking advantage of the current law loophole, making them ineligible for the PFIC exception and stopping this abuse.